RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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FEBRUARY 21, 1985 **LETTER 907**

Feb. 8 DJIA 1289.97; PTI 1697; A–D Ratio -15.70
Feb 15 DJIA 1282.02; PTI 1699; A–D Ratio -15.59

THE MARKET: In the markets history tends to repeat, but it ***never repeats in exactly the same way.*** And that's what makes stock market analysis an art rather than a science. The problem is that you study a dozen cases of previous market action, action that resembles something that is happening today. And you say, "Ah, in the past when the market did this – then such and such always followed." So you stake a fat sum on history repeating exactly – but the only trouble is that this time there's a variation. That variation costs you a bundle.

I think I've studied market breadth (i.e., the advances and declines) about as thoroughly as any man or woman alive. I was writing about the advance-decline ratio in Barron's back in the 1950's when most market practitioners didn't know there was an A-D ratio. I learned a lot of what I know about the A-D ratio from James Hughes, who was a co-inventor of the A-D ratio (along with Colonel Ayres) back in the 1930's. Hughes died many years ago, and I've always kept my records of the A-D ratio along the lines that Hughes advocated (Hughes used only daily A-D action – he had no use for the weekly or the monthly studies).

One of the A-D phenomenons which one occasionally witnesses (they are rare) is the "buying stampede" or "breadth stampede." I define a breadth stampede as any rise of five full points or more in the A-D ratio without an intervening drop of as much as a point. We saw a great example of a breadth stampede back in December 1974 through February 1975, and I wrote about the stampede extensively at that time. Here are a few of the things that I said.

(1) I wrote that during breadth stampedes the A-D tends to rise day after day with only minor hesitations. There have been some stampedes (such as the fabulous one in 1958) that lasted as long as three months.

(2) Breadth stampedes tend to occur early in bull markets rather than late.

(3) Breadth stampedes since World War II have tended to come in clusters of MORE than one and often in clusters of three.

(4) The end of a given breadth stampede occurs when the A-D ratio drops one full point or more from its highest point. In other words, you can have big down-days at any time during a breadth stampede, but it takes a full point drop on the A-D ratio to END the stampede. It would require a solid group of medium down days or at least two horrendous wipe-out days to produce a full point drop in the A-D ratio.

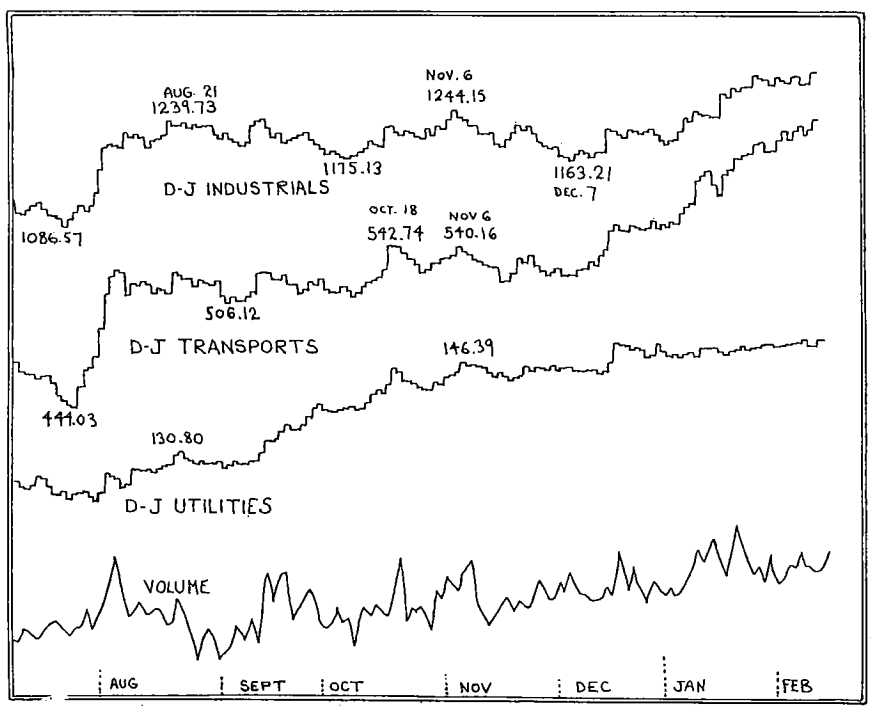
Practical application of Russell's First Rule which states that "Politicians never do anything until the screaming starts – then they do the least possible to bring the screaming down to a muffled whine."

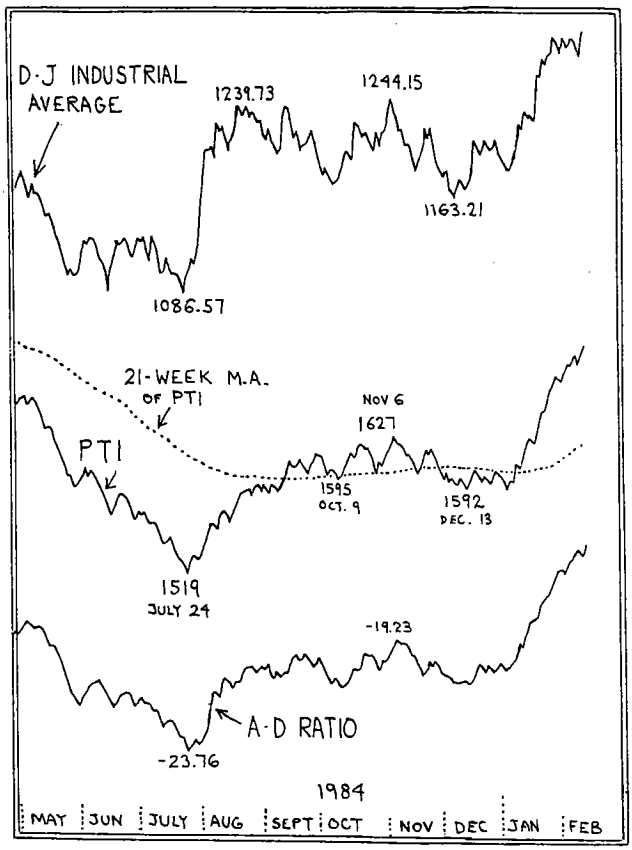
From the Feb. 15 WSJ

SPENDING CUTS may fall far short of the $50 billion target.

Senate Republican leaders back off from their call for a one-year freeze on Pentagon spending authority. But that lessens chances for a Social Security cost-of-living freeze; supporters need the military hold-down to argue that budget pain would be shared equally. The Senate's timetable slips as Dole and Domenici search for a deal.

The current breadth stampede began on my A-D ratio at minus 21.03 on December 13. As of February 6 the A-D ratio had climbed to minus 16.07, which meant that the A-D ratio on the NYSE had climbed better than 5 points without so much as an intervening one point decline. Thus, the action of December 13 through February goes down in my book as an authentic breadth stampede. The stampede will end when the A-D ratio drops a full point from whatever high is finally recorded. The 1985 portion of the breadth stampede was extraordinary in that a record was established during January. Between January 7 and January 31 the A-D ratio rose on 19 consecutive days. This is the longest period of uninterrupted rising breadth in market history. Furthermore, as of February 8 the A-D was up on 24 out of 25 trading sessions, another amazing record.





What does this kind of power performance indicate? Has the market "shot its load" on the initial tremendous 1984-85 breadth stampede – or is there more to come? Obviously no man alive can provide the ultimate answer, but based on past performance when this kind of momentum hits (accompanied by huge volume) there is more upside to come. Furthermore, as I stated earlier, it is highly unusual for only a single breadth stampede to appear. Usually, the stampedes occur in clusters of two or three. Thus, although there can be no guarantee of another stampede to come after this one has ended, the odds favor a second and even a third breadth stampede during 1985. And that may represent the single most important piece of information for investors during 1985.

At the January peak almost all the major Averages (except the Value Line) were at record highs, and by definition this indicates that (1) the primary trend is bullish, and (2) a new leg of the bull market started at the December 13 low. How far the latest leg is fated to go and how long it will last no one alive knows. The extent of a primary movement can never be predicted in advance (although an awful lot of analysts try their hand at the crystal ball).

I am asked what set of circumstances could produce a major extension of the bull market from here. In my opinion, three factors would add fire to the bullish picture: (1) obviously, rising corporate earnings, (2) a really meaningful reduction in the federal budget deficit, (3) a new tax bill which, among other things, would lower individual rates. If all of these items came to pass, I could see the market and public psychology approaching a state of absolute euphoria.

Many opinions are being expressed as to "which leg of the bull market" the current advance represents. Bob Prechter believes we are now seeing the fifth Elliott Wave in a bull market which began in 1932. Bob Farrell of Merrill Lynch thinks that this is the fourth leg of a bull market which began in 1974. Marty Zweig believes this is the second leg of a bull market that began in 1982. My own feeling is that Farrell is nearest the mark.

Call it what you may, the statistics are amazing. For instance, on Feb. 13, 14 new bull market highs were registered in (1) all five NYSE indices, (2) the four D-J Averages including the D-J 65, (3) five of the six S & P Averages with the S & P Transports missing a new high by only 2 points. I can't remember the last time I saw 14 out of these 15 averages hitting new bull market highs. This occurred, by the way, with the A-D ratio up an astounding and record 26 out of 28 trading sessions.

What can we say here? We can say that this market has a head of steam on it that has few parallels in market history. We can say that so far the market has been remarkably resistant to correction. Nevertheless, it is well to remember that all price movements, primary, secondary and minor, are subject to corrections that tend to retrace one-third to two-thirds of the previously uncorrected advances or declines. We can also say that the majority of corrections begin with ***non-confirmations*** or ***divergences.*** At this point neither of these aberrations is present.

INVESTMENT POSITION: We continue to hold everything, stocks, bonds, no-load funds. The bull is in the box and the charts on pages 1 and 2 tell the story. From its December 13 low of 1588, the PTI has now risen 117 points almost straight up. So the market could be overdue for a pause or more. The yield on the D-J Industrial Average is now down to 4.2%, the Transports down to a tiny 2.3%. Yet the market still shows great reluctance to decline.

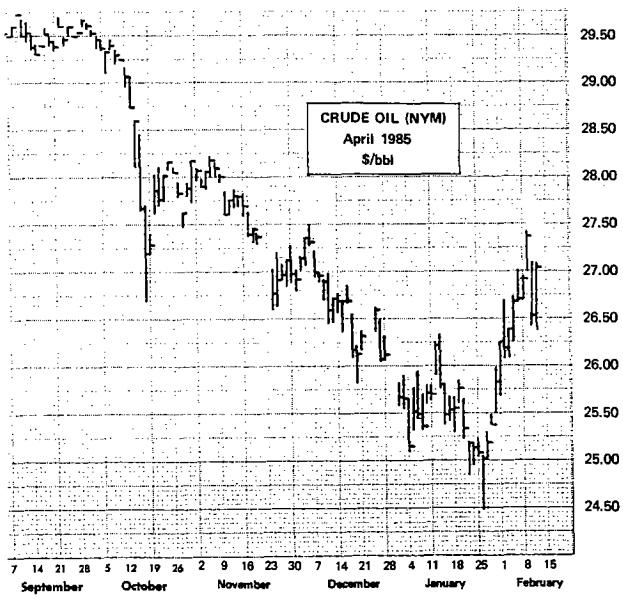
If the Dow is going to perform, the strongest stocks in the Dow will have to be part of the party. The strongest now are Amer. Express, Exxon, DuPont, Gen. Electric, United Technology, Westinghouse, Woolworth. You could do a lot worse than holding a package of these. For no-loads funds Fidelity's Equity Income or Magellan are fine (1 800 225 6190) or Mutual Shares (1 800 221 7864 and in NY 908 4048).

ROUNDUP: The bear market in commodities has been very serious, the more so since the super-strong dollar has hurt US agricultural exports so badly. For farmers and commodity traders, 1984 and '85 have been pure torture (despite what you hear, commodity traders don't do well in bear markets).

I've been watching certain key commodities very carefully over the past month. I've been watching them for signs of renewed inflation. I have picked out five key commodities which could signal a resurgence of inflation, and each of these is now in position to break out on the upside. The five are listed here with the key upside points to watch on each (any of these upside buy points, if reached, could also be an early inflation signal): (1) April gold with the key point at 315, (2) March silver, key point 6.50, (3) March copper at 64 and this is a

particularly strong picture, (4) March palladium at 133, (5) April crude oil at 27.50--here's a real contrary opinion, but oil has rallied strongly despite the fact that everyone expects a collapse.

The whole world is watching the dollar now. The foreign currencies have literally "blown out" on the downside, and I am wondering if the dollar is not near its ultimate high. When the turn comes, it's going to be led by the Japanese yen and confirmed by the metals. I don't care what anyone says, I think the fundamentals for the dollar are thin--very thin.



In his 1984 scoreboard, the Hulbert Financial Digest rates Dow Theory Letters as number 2 in "The 10 Least Risky of 1984" category. And this suits me fine. I don't like to risk my own money unnecessarily, and I like risking my subscribers' money even less. Any damn fool can jump in and out of the market and make a few good trades and few bad ones. And any fool can spin the wheels or play dice in Vegas. But to me, money represents sweat and hard labor (of course if you inherited the money, it's somebody else's sweat and hard labor). And I don't like playing games with my own labor or that of my subscribers.

Last May and June I strongly recommended bonds as a high-value and timely investment for my subscribers. I thought the risk was minimal and the chances of real investment gains were high. Events proved that call to be correct, and I have received dozens of letters from subscribers expressing satisfaction for an investment that has brought both high yield and appreciation.

The T-bonds are acting toppy here, and my feeling is that they may have completed their upside move. The key of the commodity picture in that a close at 70 on the March bonds would indicate rising interest rates and probably inflation. At 70 on the March contract I would also suggest that my subscribers take profits on most of the bonds that we bought last May.

NOTE: Why the change in type on page 2? Sadly, my $15,000 faithful IBM Composer finally burned out. So I am typing the rest of this Letter on a back-up IBM 85. But by the next Letter, we will be back with a new smaller type (smaller than this), and I believe a much-improved look. So my apologies for changing typestyle and size in mid-Letter. But through disasters come improvements.

ZEROS: Zero-based bonds have been quite hot for quite a while now. But I don't like them, and I've written about my philosophical objection to the zeros before. I want to write more. The crux of the zero-based bond is that you buy the bond at a big discount, the discount based on interest you never actually receive. But you will get paid the face amount at maturity. The advantage of the zero is that you are compounding at predetermined rates of interest, and therefore you never have to worry about reinvesting your interest at perhaps lower or undetermined rates in the future.

Philosophically, I hate the zeros because they are more of the same kind of thinking that has produced the deficit mess the nation is now in. The zero is the essence of "grab the money now and pay later". The company (or the government) borrows the full face amount now and they pay nothing on the bond until maturity. Then they pay the full amount. Since there are no interest costs until maturity, the zeros are tantamount to a free ride for the seller until the piper is paid in 1990 or 2000 or whenever the bonds mature.

For the zero buyers, the risks are (1) the buyer received no interest on the bond until maturity. Thus, he has no chance to get at least part of his money as the bonds slowly mature. (2) In receiving no interest for the life of the bond, the zero-buyer forfeits the chance to diversify, a critically important part of intelligent investing. To illustrate, the buyer of a straight bond receives

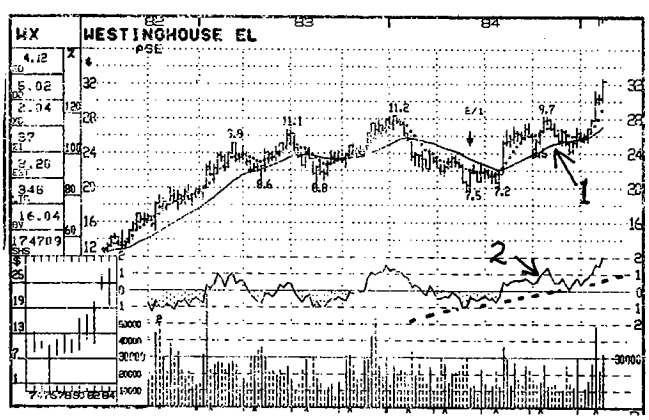
interest every six months. He can reinvest that interest in other bonds or in stocks and thereby diversify his position. The zero bond holder is locked into his original investment.

The question arises, suppose I buy zero Treasury bonds? What's the risk there? My answer is, " Probably not much, but who the devil knows?" As far as I'm concerned, IBM stock or Exxon bonds might prove to be better than Treasury bonds. That's where diversification comes in. You diversify because nothing is sure in investing -- even the US government.

As for the philosophy of zero bonds (and I am endebted to Jim Grant of Grant's Interest Rate Observer for this), consider the following: if you buy CATS at a 12% yield, those zeros will appreciate by 1,751% by 2009. To equal that the D-J Industrial Average (not including Dow dividends) would have to hit 21,298 by 2009.

Would anyone bet that the Dow will hit 21,298 by the year 2009? Sure it's possible--but it's also improbable. Does anyone think that the Treasury will pay off the zeros in 2009? Who knows? What I'm saying here is that it's immoral to grab the money now with the promise to pay later. When you see what zeros are committed to pay later, it makes you wonder if we're not now seeing the greatest scam in financial history.

STRENGTH: A lot of new subscribers ask me how I pick a stock on a technical basis. There are a number of techniques, but sometimes keeping it simple is best. The simplest method is a two- step analysis. (1) Is the stock acting better than the market? (2) Is the stock acting better in relation to its own recent performance?



Both questions are answered on this Mansfield chart. Arrow #1 shows that Westinghouse has risen above its own moving average; in other words, WX is now acting better than it did on average over the last 10 weeks. Arrow #2 refers to relative strength, and here we see that WX is also acting better than the market. Under these two conditions, WX has to be considered one of the strongest stocks in the Dow. The final proof, of course, is that WX has broken out into new high ground. Yes, I like WX.

NEW PAGES: The 1984 pages are now ready for all those who have our chartbooks of the D-J Averages and the daily advance-decline ratio. The first page traces the action of the D-J Industrials, Transports, Utilities and 20-bonds, together with daily volume. The second page traces the daily advance-decline ratio and the daily Dow closings. The pages are $2 each and they should prove to be invaluable for serious investors and market students.

NOTES & QUOTES: Here are the official figures on US debt right up to date. Note that the total debt is pushing $1.7 trillion (remember when it was a trillion?). Note that total interest for the first fiscal quarter was $49.3 billion. Annualized, that's $197 billion for the year or $3.8 billion a WEEK! When you pay out $3.8 billion a week in interest, you cannot take a big contraction in tax receipts. That's why I say, the US can no longer afford a recession. The next recession (with contracting tax receipts to the Treasury) will be a disaster (is it any wonder Mr. Reagan in his inaugural address called for "new heights of progress?).

U.S. Finances

for Wednesday, Feb. 6, 1985

WASHINGTON (AP) — Here are figures on government spending and debt (last six digits are eliminated). The government's fiscal year runs Oct. 1 thru Sept. 30.

Total public debt Feb. 4	1,673,406
Interest on public debt Dc.	23,373
Interest fiscal year thru Dc.	49,387
Projected deficit fisc1 1985	222,200
Actual deficit fisc1 1984	175,342
Receipts fiscal year thr Dc.	166,148
Receipts period last yr	149,403
Outlays fiscal year thru Dc.	238,576
Outlays period last yer	212,725
Gold assets thr Oct.	11,096

* *

The extraordinary strength in the dollar continues to play havoc with America's farmers (who have been practically priced out of the world markets). Furthermore, at the urging of the US government and the local bankers ("plant fence to fence, guys")

farmers speculated on land and huge crop plantings, only to become mired in debt. This piece from a front-page NY Times article (Feb. 10) tells the pitiful farm story:

> **KANSAS CITY, Mo., Feb. 9 — Economic problems of a size not seen by generations of Americans are wrenching farm life and rural communities across the country's principal food-producing regions.**
>
> **Evidence is mounting that fear and despair are spreading among hundreds of thousands of farmers who are looking at losses of millions of acres, farms either already lost or likely to fall into the hands of creditors soon.**
>
> **They are among the nation's 2.37 million farmers who are struggling to pay interest on total liabilities that have soared 63 percent since 1979, from $132 billion to $215 billion. The interest on that now totals more than $21 billion a year, as against a total farm income averaging $23 billion a year in the past two years.**

* *

Retreating from communism works. Chinese peasants have increased their productivity on farms an average of 12% a year for the past seven years. This has made China the world's largest wheat producer.

* *

Who's more likely to go to court, a rapist, a burglar or an obstetrician? In the US, it's an obstetrician. A full 60% of all obstetricians have been sued at least once and 20% two or three times. Last year the median verdict against the obies was $1.4 million. Tell your son to be a vet.

* *

Francis Kelly (research director of Oppenheimer & Co.) is a very smart guy, and I'm always interested in what he says. He states that budget cuts alone, paradoxically, may bring about larger deficits. Why? Since 1980, the dollar has climbed 40% against other major currencies and as a result US manufacturers have lost large amounts of sales to foreign firms. If spending is cut by government and foreign sales remain compressed, tax receipts are going to fall off (due to a fall in output). To counter this, the Fed will have to reflate the money supply. The reason: inflating the money supply will bring the dollar down and make US products more competitive in world markets. Russell comment: In the four weeks ending January 1985, total reserves grew at a 26.6% rate, and this has even disturbed the Fed. In other words, the money supply IS booming and the dollar still remains strong!

* *

What happens in the US during the course of a day? Here are some interesting examples. (1) 50,000 new TV sets are sold (there are now more TV sets than telephones in US homes). (2) 200,000 tons of edible food are thrown away. (3) Sixty people desert the military and about 200 go AWOL. (4) 2,200 people discover that they have cancer. (5) Two American public officials are indicted on corruption charges. (6) Twenty trains accidentally jump their tracks. (7) More than 8,000 Americans become pregnant by mistake. (8) $125,000 is spent on tours and merchandise associated with Elvis Presley. (All courtesy of Mother Jones)

"In Search of Excellence" has been on the best seller list for about a year. But Dale Carnegie's "How to Win Friends and Influence People" (published in 1936) has gone through 200 hardback and paper editions and has sold over 15 million hardback copies and spent 10 years on the NY Times best seller list. The book has been translated into 30 languages and still sells big today. More than that, the Dale Carnegie Course in Effective Speaking is the most popular venture in US educational history with 3 million people having graduated from the course and 2,000 students enrolling weekly. Carnegie himself had few business credentials and first earned his reputation as a debater in State Teacher's College of Missouri. His business experience: selling bacon for Armour in S. Dakota.

* *

BOOKS: After the bear market of 1973-74, stock market books fizzled, and during the early '80s the stock market books just about disappeared. Now, however, a number of good books have appeared. Not all strictly stock market books, mind you, but investing books. I've listed below some of the available books that I like.

(1) "The Tao Jones Averages" by Bennett Goodspeed (Penguin paperback), a fine book that makes the point that the little guy can compete with big-time institutional and brokerage analysis. How? By using his intuition, a factor no computer or board can handle. Well worth reading.

(2) "Wall Street Insiders" by John Boland (Morrow), a good look at what the insiders are doing, how they operate and how they affect you.

(3) "Famous Financial Fiascos" by John Train (Potter), one of my favorite writers authors a little volume that is fascinating (everyone loves a disaster -- as long as it's somebody else's).

(4) "Behavior of Prices on Wall Street" by Arthur Merrill. You buy this one from the Analysis Press, Box 228, Chappaqua, NY 10514 for $35 but it's worth it. Merrill is unsurpassed in the field of technical analysis.

(5) "Financial Passages" by Ben Stein (Doubleday), a volume which contains a large amount of a very scarce commodity -- common sense. Stein knows all about compounding so naturally he's A-1 with me.

(6) "The Book of Granville" by Joe Granville (St. Martins). He's a wild and crazy man. Many disagree with him, many call him brilliant, but nobody every called Joe boring. Here's his own story, and it's fascinating reading. Joe loves drama and excitement and could probably start a riot in the Somnambulists' Club. When J.G. finally retires, who is there to take his place?

GOLD I get lots of letters, most of them friendly and constructive. Here's one from a Professor at the University of S. Africa in Pretoria (received last week). He writes, "Dear Mr. Russell, in case you are interested to know why your subscribers sometimes renew their subscriptions, in my own case, the main reason by far is your gold column. During the two-and-a-half years that I have been following your Letter, you seem to be consistently reliable in this respect.....I find your gold column in fact by far the most accurate, clear and consistent of your various coverages. Why not then expand it, instead of relegating it always to a relatively small section on your back page?..."

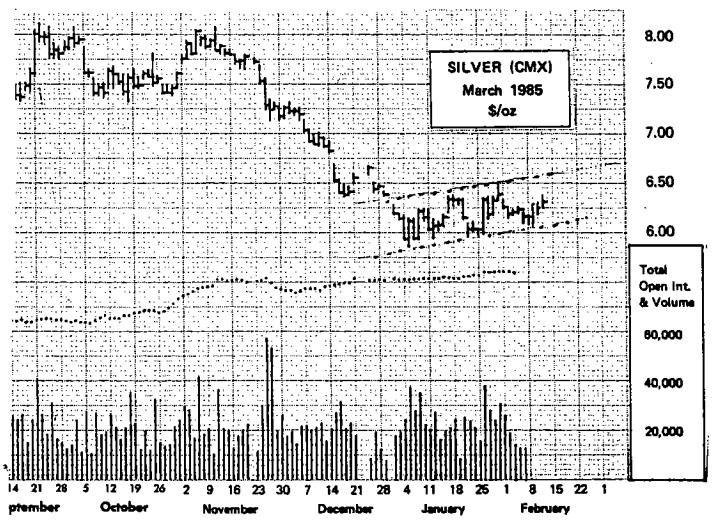
The answer is that I try to write most about where the action is. Back in the late 1970's when gold was "hot," I filled the Letters with gold talk. But now my ratio of gold to NYSE Index (stocks) has just fallen to a new multi-year low. Gold has cooled off, and what's hot today are stocks, bonds, and (sadly) federal debt. That's where I'm looking right now, and that's what I write about. A year from now if coins or gold or farm land is where it's at, I'll be writing about them.

All right, gold. Collapsing foreign currencies (in terms of dollars) have made gold look bad to Americans. But actually, you can say that gold has been the second strongest currency. Consider this: in terms of British pounds, gold today (at $300 per ounce) is higher than it was in late-1980 when gold was $600 per ounce. In other words, in terms of pounds gold is higher today than it was in late-1980. In terms of Swiss francs gold is slightly lower today than it was in late-1980--but not much lower.

One phenomenon is now worth watching. Despite the continuing collapse of foreign currencies, gold has not yet broken below 295. In other words, aside from the dollar, gold has been pretty strong recently in terms of almost any non-dollar currency.

What does this mean? To me it means that there has been some buying of gold by non-dollar nations and investors. They haven't dumped gold along with their own currencies. They may yet--but they haven't recently. Technically, that's (in my opinion) the biggest plus for gold today.

This daily chart (courtesy of Dunn & Hargitt) shows six months of silver action. If the March contract goes over 6.50, this would be a bullish signal as would the April gold contract at 315. Until then, just watch the metals. The hints of better action are there--but we don't move on hints, we move on the action itself!



LATE NOTES: We have just witnessed 25 consecutive days of over-100 million shares volume on the NYSE, another all-time record. We've had some "churning" over the last few days, and churning on high volume often leads to violent moves -- some of them down. Therefore, latecomers had best be careful about buying here. I continue to watch the dollar carefully. The yen is beginning to move up against the dollar, with the other currencies still showing little. 90% of the Dow stocks are now rated bullish, confirming an over-bought market.

NEXT MAILING: March 6